1.05 Credit Losses

Overview

ASC 326 specifies the reporting for declines in the value (ie, credit losses) of financial assets, such as accounts receivable and loans receivable, that result from the expected inability of the debtor to make all of the payments called for in the instrument. There are two types of assets that are subject to the recognition of credit losses under ASC 326 (referred to as the *current expected credit loss* or CECL method):

- Assets measured at amortized cost* (discussed here)
- Available-for-sale (AFS) debt securities (differences in accounting are discussed in a later section)

****Amortized cost*** *is the amount at which a financial asset originates or is acquired, adjusted for accrued interest, accretion, amortization, collections, writeoffs, and other accounting adjustments.*

Assets Reported at Fair Value

Financial assets reported at fair value generally are not subject to the recognition of credit losses. This is because fair value is determined on the basis of market transactions, which assumes that the risk of credit loss is taken into account when the buyer and seller determine the exchange price.

While AFS debt securities are reported at fair value, if the fair value is lower than the present value of expected future cash flows, the instrument generally will be held and the cash flows will be realized. If, however, the fair value is higher, it generally will be sold at its fair value rather than being held for the cash flows. As a result, the allowance for credit losses would never be greater than the amount by which the amortized cost exceeds the fair value.

Assets Measured at Amortized Cost (and Other Assets)

The following assets measured at amortized cost are subject to the recognition of credit losses:

- Accounts receivable resulting from recognizing revenue (under ASC 605, 606 and 610)
- Financing receivables
  - Defined as a contractual right to receive money on demand or on fixed or determinable dates, and which is recognized in the balance sheet.
  - Examples include loans, trade accounts receivable, notes receivable, credit cards, and certain lease receivables.
- Held-to-maturity debt securities
- Financial assets addressed in ASC 860, which concerns transfers and servicing of financial assets (eg, mortgages transferred to Fannie Mae but serviced by Wells Fargo)

Credit losses also may be incurred in relation to other assets, including[2]:

- A lessor's net investments in leases (ie, sales-type and direct financing leases)
- Off-balance-sheet credit exposures that are not accounted for as insurance, such as:
  - Off-balance-sheet loan commitments
  - Standby letters of credit
  - Financial guarantees
  - Similar instruments other than derivatives that are subject to the provisions of ASC 815, *Derivatives and Hedging*

Exclusions

There are some financial assets that are **not subject to credit losses**:

- *Financial assets measured at fair value* with changes reported in net income (eg, equity securities and trading debt securities).
- Loans by defined contribution employee benefit plans made to participants.

  Since these loans are generally limited by a participant's interest in the plan, the participant absorbs the loss, not the plan.
- *Loans of an insurance entity made to the policy owners*, which are also generally limited to the owner's net investment in the policy's surrender value.
- *Promises to give recognized by a nonprofit entity*, such as pledges receivable, since pledges are not made in exchange for goods and services and are often not legally binding commitments.
- *Loans and receivables between entities under common control* since these represent the principals of both companies essentially making a loan to themselves.
- *Operating lease receivables*, which are accounted for under ASC 842.

Recognizing Expected Credit Losses

Allowance for Credit Losses

Rather than reduce the recorded balance of a financial asset, credit losses are accumulated in a contra-asset account (ie, valuation account)—**Allowance for Credit Losses**. The carrying value is measured at amortized cost, using the effective interest rate at the inception of the instrument, and is reduced by the allowance for credit losses. On each reporting date, the allowance is adjusted so that the net amount equals what management expects to be collected.

- Increases in the allowance are reported in a **Credit Loss Expense** account.
- Decreases in the allowance are reported in a **Reversal of Credit Loss Expense** account.

[2] *This list also includes reinsurance recoverables resulting from insurance transactions under ASC 944. Since these transactions are industry specific, and thus generally not tested, we have excluded them.*

Pooling Assets

Financial assets that have similar risk characteristics are considered a pool and are evaluated for credit losses on a collective basis. While it is difficult to determine if a specific instrument is collectible without a significant investigation, averages can be applied to groups of similar assets. Financial assets that do not have similar risk characteristics are evaluated individually. No financial assets should be evaluated both separately and on a collective basis.

Measuring the Amount

In performing the evaluation of credit losses, a variety of methods may be applied, such as the following:

- *Discounted cash flow method* – Losses are estimated by determining the present value of the expected future cash flows.
  - Although the discounted cash flows method is widely used, it is not required. Also, when another technique is applied, there is no requirement to evaluate the results by comparing them to the results derived under the discounted cash flows method.
- *Loss-rate method* – Losses are estimated as a percentage of total exposure.
- *Roll-rate method* – Losses are estimated on the basis of the time required for the conversion cycle, the period required for instruments to be realized.
- *Probability-of-default method* – Losses are estimated by multiplying a likelihood that an instrument will be defaulted upon by the balance of the instrument.
- *Aging method* – The instruments are stratified, often on the basis of when they will mature, and different percentages are applied to each stratum.

When credit losses are estimated by applying a **discounted cash flow method**, expected future cash receipts are required to be discounted using the **effective interest rate** of the financial instrument being evaluated. The valuation allowance under this method will equal the difference between the amortized cost and the present value of the future payments expected to be collected.

When financial assets have a contractual rate that varies based on an index, the effective interest rate will take into account the changes that have occurred over the life of the instrument. The effective rate may *not*, however, take into account *projected changes*. Other factors that should *not* affect the effective interest rate include the following:

- *Expected credit losses* - The effective rate is the rate at inception that will result in the present value of expected future cash inflows that will equal the issue price of the instrument. If it is determined that less will be received, the effective rate is not adjusted to cause the present value of expected collections to equal the carrying value, which will result in recognizing lower amounts of interest income without recognizing the effects of credit losses.
- *Effects of expectations of extensions, renewals, or modifications of the instruments*, unless a troubled debt restructuring with the debtor is reasonably expected to occur as of the reporting date.

Prepayments may be taken into account in measuring credit losses. This is also true of estimated future prepayments and future interest cash flows when inclusion is consistent with the method being applied. All available relevant information should be considered, including internal and external information. Reliance should not be placed exclusively on historical loss information and both qualitative and quantitative information should be considered.

Off-Balance-Sheet Risk

An entity may have a risk of credit loss that is not associated with a financial asset or any other item(s) that are reported on the balance sheet. This results in an off-balance-sheet risk of credit exposure.

A common example is an entity's guarantee of another entity's obligations. If the other party is not able to satisfy its financial obligation, the guarantor entity will be required to do so. Unless the obligation is *unconditionally cancellable*, it will result in a credit loss that is required to be reported on the entity's F/S.

Credit Enhancements

Some entities will reduce exposure to credit losses through the use of credit enhancements, such as requiring a guarantor. Factors that include the guarantor's financial position, its apparent willingness to pay its obligation if necessary, or the existence of subordinate obligations all affect the estimate of credit losses. Assets or other instruments obtained or entered into for the purpose of mitigating these losses may not, however, be used to reduce amounts reported.

For example, an entity may acquire a credit default swap to protect it against potential credit losses in relation to a mortgage note receivable. If the potential for default requires the recognition of a credit loss and an allowance for credit losses, the positive value of the credit default swap may not be offset against the loss.

Purchased Financial Assets with Credit Deterioration (PCD Assets)

If an entity acquires a financial asset with credit deterioration (ie, more than an insignificant amount), it will likely be purchased at a larger discount because of the potential for credit loss. As a result, the discount is based **on** both market risk due to a potential difference between the instrument's stated rate and a comparable market rate, and credit risk due to the potential of noncollection. This discount must be appropriately allocated:

- The portion associated with market risk, may be a discount, premium, or neither, depending on whether the stated rate is higher, lower, or equal to the market rate, respectively. Such a discount or premium is recognized as an *adjustment to the carrying value of the instrument and is amortized under the effective interest method*, affecting interest income.
- The remainder, which is associated with credit risk, is not recognized and amortized in relation to interest expense. The initial amount is instead added to the cost of the investment and accounted for in the same manner as other credit losses.

After the initial acquisition and recognition of a financial asset, a current estimate of expected losses is measured each reporting period, using the same measurement technique as was used originally. The allowance is adjusted to the appropriate amount and the related increase or decrease in the allowance is recognized as an additional credit loss expense or a reversal. The same is true for off-balance-sheet credit exposures.

- As discussed previously, financial assets with similar characteristics will be evaluated as a pool.
- Those that do not have characteristics that are similar to others will be evaluated separately.

Collateral

Many financial assets are secured by collateral to provide the holder another means of recovering the investment it made. Regardless of the initial measurement method of expected credit losses, when it becomes **probable** that the financial asset will be settled through exercise of lien rights and foreclosing upon the collateral, the entity will report the financial asset at the fair value of the collateral (less costs to sell the collateral, if applicable).

Changes in the value of collateral may require continual adjustments to the allowance for credit losses; thus, in these circumstances, there is a practical expedient that allows the entity to measure the allowance by simply comparing the amortized cost of the financial asset to the fair value of the collateral on the reporting date.

- In some arrangements, the debtor is required to replenish collateral when values decline to make certain that the value of the collateral always exceeds the amortized cost basis of the financial asset, eliminating the need for an allowance.
- Many entities borrow using merchandise inventory for collateral with terms requiring the borrower to maintain inventory according to some ratio. When a secured line of credit cannot be drawn down to an amount exceeding 80% of the outstanding balance of the loan, for example, as inventory is sold, the debtor is required to either replenish inventory or pay down the loan to maintain that ratio.

Writing Off Financial Assets

Financial assets are required to be written off (partially or in full) in the period in which it is determined that they are **uncollectible**. The asset is reduced to zero and the allowance for credit losses is decreased by the same amount. Recoveries of amounts written-off should be credited back to the allowance for credit losses.

Change in Classification of Loans

When a decision has been made to sell a loan that is not currently classified as held for sale, the loan is transferred to the held-for-sale classification; however, any uncollectible portion of the amortized cost basis will need to be written off before the loan is transferred to the held-for-sale classification.

Measuring Interest Income on PCD Assets

ASC 326 does not provide guidance on the recognition of interest income by the holder of the instrument. Some entities apply a method, such as the cost-recovery method or a cash-basis approach, under which the amount expected to be collected exceeds the amortized cost. When a financial asset is purchased with credit deterioration:

- The discount associated with the deteriorated credit of the debtor is accounted for (separately from other discounts or premiums) using an allowance for credit losses, with adjustments increasing or decreasing the amount of losses recognized.
- The other discounts or premiums are generally the means by which the instrument's effective rate is adjusted to approximate the existing market rate, and amortization is a component of interest income.

Income from PCD assets can only be determined if amounts to be collected can be reasonably estimated. Once the PCD asset is initially recognized, the entity may place it on nonaccrual status so that income that is not likely to be received will not be reported.

Such a financial asset may be acquired, however, to provide the entity with the benefits to be derived from operation of the underlying collateral. When this is the case, interest income may be recognized, but it is limited to the extent that its recognition would increase the net investment reported to an amount greater than the actual payoff amount.

Financial Statement Presentation

Balance Sheet

- When presenting financial assets measured at amortized cost on the balance sheet, the allowance for credit losses is to be reported separately from the amortized cost of the financial asset.
- Off-balance-sheet credit risk exposures are to be reported as expected credit losses in the liability section.
  - The liability is reduced or eliminated, as appropriate, when the instrument expires, results in the recognition of a financial asset, or is otherwise settled.
  - Estimates of expected credit losses related to off-balance-sheet credit risk are to be reported separately from the allowance for expected losses related to recognized financial assets.

Income Statement

- Changes in the present value of a financial asset from one reporting period to the next may result from the passage of time as well as from changes in estimates of the timing or the amounts of future cash flows to be received. When credit losses are measured using the discounted cash flow approach, the entity may either:
  - Report the entire change in fair value as credit loss expense, or
  - Recognize the portion of the change attributable to the passage of time as interest expense and the remainder as credit loss expense.
- Changes in the fair value of collateral securing a financial asset that is collateral-dependent are reported as:
  - Credit loss expense for decreases.
  - Reversal of credit loss expense for increases.

Credit Loss Disclosures

Disclosures related to credit losses associated with financing receivables, which also apply to the net investment in leases, may be provided for each portfolio segment or for each class of financing receivable. Disclosures related to investments in debt securities are to be provided for each major security type. The level of detail required is to be determined by considering the surrounding facts and circumstances.

The required disclosures are designed to provide a user of the F/S with an understanding of the following:

- The credit risk associated with an investment portfolio and how it is being monitored by management
- An estimate of credit losses
- Changes in the estimate

Disclosures regarding **credit quality** should enable F/S users to understand how management monitors credit quality and assesses the risks resulting from the credit quality of its financial assets. It is required to include both qualitative and quantitative aspects. Disclosure, by class of financing receivables and major security type, will include:

- Information about credit quality indicators used to evaluate it, except for receivables measured at the lower of the amortized cost basis or market value, or trade receivables due within one year.
- The amortized cost basis of financial assets, organized by the credit quality indicator applied.
- The date on which the information was updated, or range of dates, for each credit quality indicator.

These disclosures apply to financing receivables and a net investment in a lease. They are not required for off-balance-sheet credit exposures. Nor do they apply to reinsurance receivables or repurchase agreements and securities lending agreements.

- The amortized cost basis is presented for financing receivables and the net investment in leases, with few exceptions.
- Amounts are reported within each credit quality indicator by year of origination, using the initial date on which the instrument was issued, not the date on which it was acquired.

Disclosures related to the **estimation of credit losses** should enable F/S users to understand how the allowances for credit losses were developed; the information used in developing current estimates; and circumstances responsible for changes to the allowance, affecting the period's credit loss expense. The disclosures, required to be presented by portfolio segment and major security type, include:

- How expected loss elements are developed
- Accounting policies related to estimating the allowance for credit losses and the methodology applied, along with factors considered, such as past events, current conditions, and forecasts that are reasonable and supportable
- Risk characteristics of each portfolio segment
- Changes in factors influencing management's estimates
- Changes to relevant accounting policies and methods applied, including their rationale and quantitative effects
- Reasons for significant changes in write-offs, if any
- The reversion method applied for periods too distant to enable reasonable and supportable forecasts
- Significant purchases of financial assets that occurred during the period
- Amounts of significant sales or reclassifications of financial assets

Creditors choosing to report interest expense based on changes due to the passage of time and credit losses separately, as opposed to combining them and reporting the total as credit loss expense, are also required to disclose the amount of interest income representing changes in present value due exclusively to the passage of time.

F/S users should be able to understand activity causing changes in the allowance for credit losses for each period, and separately by portfolio and major security type. Disclosures related to the allowance for credit losses are to include:

- The beginning balance
- The current period's provision for expected credit losses
- The amount initially recognized in the allowance for PCD assets, if any
- Writeoffs charged to the allowance during the period
- Recoveries of amounts previously written off
- The ending balance

An aged analysis of the amortized cost basis for financial assets past due as of the reporting date is to be provided by class of financing receivable and by major security type, indicating when a financial asset is considered to be past due. The disclosures related to the instruments' past due status is *not* required for:

- Receivables measured at the lower of amortized cost basis or fair value
- Trade receivables due in one year or less, unless they are credit card receivables resulting from transactions that provide revenue

When financial assets are placed on **nonaccrual basis**, users should be able to understand the credit risk, and the interest income recognized, by class of financing receivable and major security type. The disclosures will provide:

- Their amortized cost basis at the beginning and end of the reporting period
- Interest income recognized
- The amortized cost basis of financial assets not on nonaccrual status on the reporting date, despite being past due for 90 days or more
- The amortized cost basis of financial assets that are on nonaccrual status but do not have an allowance for credit losses

In an entity's summary of significant policies for financial assets, excluding receivables measured at the lower of amortized cost basis or fair value, or trade receivables, other than credit card receivables incurred in transactions falling under the guidelines of revenue recognition (ASC 605) or revenues from contracts with customers (ASC 606), the following should be included:

- Nonaccrual policies, including those related to discontinuing and renewing the accrual of interest, as appropriate
- Policies for determining when a financial asset is past due or delinquent
- Policies for recognizing writeoffs

If financial assets with credit deterioration were purchased during the current period, the following should be disclosed:

- The difference between their par values and their purchase prices should be reconciled, showing the purchase price

- The acquiring entity's assessment supporting the allowance for credit losses at acquisition
- Any discount or premium attributable to factors other than the credit deterioration
- The par value

Disclosures also will provide information about financial assets that are collateral-dependent and off-balance-sheet exposures.